In the Supreme Court of the United States

OCTOBER TERM, 1967

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

TRINITY UNIVERSAL INSURANCE COMPANY AND FIRST NATIONAL BANK IN DALLAS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in the above case.

OPINIONS BELOW

Neither the findings of fact and conclusions of law of the district court (R. 75–83),[1] nor the opinion of the court of appeals (App. 9–15), are yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1967 (App. 15–16). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." references are to the printed record in the court of appeals. "App." refers to the Appendix to this petition.

284-336—67——1

QUESTION PRESENTED

Whether the United States' right to set off a contractor's unpaid tax debts against a fund it had retained from payments due the contractor before his default on a government construction contract is superior to the claims against the fund of the surety on the contractor's performance bond, the surety having elected to complete the contract in lieu of paying damages to the United States.

STATEMENT

Dallas Building, Inc., was awarded a contract for the construction of a nuclear warfare laboratory at Kirtland Air Force Base, Albuquerque, New Mexico, on March 30, 1961, for the total sum of $1,008,889.36 (R. 75–76; App. 9). Respondent Trinity Universal Insurance Company executed as surety the two bonds required by Section 1 of the Miller Act (Act of August 24, 1935, c. 642, 49 Stat. 793, 40 U.S.C. 270a), one to guarantee the contractor's performance and the other to guarantee payment of laborers and materialmen.

When 90 percent of the contract had been completed the contractor defaulted. The United States terminated its right to proceed further. Under the contract the United States had retained, from progress payments due to the contractor, $39,906.96. There was work remaining to be done having a contract price of $67,276.16. As of that date, federal unemployment,

withholding, and F.I.C.A. tax liabilities of the contractor of $6,495.07 were unpaid. (R. 76; App. 10.)

The surety, in discharge of its obligations, agreed to take over and complete the contract. It paid $116,623.37 to have the work done. The United States paid the surety the contract price of $67,276.16 for that work. In addition, the government paid the surety $33,411.89, this being the difference between the $39,906.96 retainage for work done by the contractor before default and the $6,495.07 owed by the contractor for taxes. (App. 10.)

The surety then brought suit under 28 U.S.C. 1346 (a)(2) to recover the $6,495.07 setoff.[2] The district court rejected the claim upon the authority of *United States* v. *Munsey Trust Co.*, 332 U.S. 234. (App. 11). The surety appealed, and the Court of Appeals for the Fifth Circuit reversed, holding that the United States' right of setoff was inferior to the surety's claim to the retained fund (App. 15, 16).

REASONS FOR GRANTING THE WRIT

1. The Court of Claims in *Standard Accident Ins. Co.* v. *United States*, 97 F. Supp. 829, in circumstances identical to those of this case, held that the

[2] The First National Bank in Dallas, to which the contractor had also assigned its contract rights against the government, joined in the suit. The district court held that the sole purpose of the assignment of contract rights to the bank was to deprive the government of its right to setoff for its taxes. (R. 81.) On appeal the bank dropped its action based on the assignment, and only the rights of the surety are in issue.

government's right to a setoff is superior to the claims of a surety. As the Fifth Circuit acknowledged (App. 14), there is a direct conflict between it and the Court of Claims.

2. The question presented is of substantial importance, and it is therefore appropriate for this Court to resolve the conflict.[3] *United States* v. *Munsey Trust Co.*, 332 U.S. 234, held that the United States has a right of setoff against a retained fund that is superior to the rights of a surety on a Miller Act payment bond. This Court did not have before it, and did not decide, the question whether the same result would follow in the case of a performance bond. Although parts of this Court's opinion in *Munsey Trust* may be read as suggesting that the rule might be different

[3] The Federal Tax Lien Act of 1966, P.L. 89-719, 80 Stat. 1125, Sec. 105(b), added the following subsection to Section 1 of the Miller Act:

> (d) Every performance bond required under this section shall specifically provide coverage for taxes imposed by the United States which are collected, deducted, or withheld from wages paid by the contractor in carrying out the contract with respect to which such bond is furnished. * * *

The amendment became effective November 3, 1966, subsequent to the time when this controversy arose. The purpose of this amendment was to make sureties absolutely liable for tax liabilities of the contractor arising from the contract subject to the bond, whether or not there were retainages against which a setoff could be asserted (S. Rep. No. 1708, 89th Cong., 2d Sess., p. 23). The record before the district court showed (R. 3, Ex. 1) that at least some of the taxes at issue in this case related to 1959, before Dallas Building, Inc. began work on the job whose performance Trinity Universal guaranteed, and this case therefore poses an issue not resolved by the new Act. (Exhibit 1 is not in the printed court of appeals record. A copy is being filed with the clerk.)

in the latter circumstance, see 332 U.S. at 242–243, the United States has routinely exercised the right of setoff against a surety on a performance bond who elects to complete the contract, and thus becomes entitled to the retained fund. The paucity of litigated cases[4] suggests that sureties, just as routinely, have acquiesced in such setoff. The decision below, in holding that the setoff is improper, is likely to increase litigation of this issue, unless the resulting uncertainty is put to rest by this Court.

3. We submit that the decision of the court of appeals is erroneous and that the conflicting decision of the Court of Claims in *Standard Accident Ins. Co.* v. *United States, supra,* is correct. The Fifth Circuit's analysis turns on its conclusions that "the surety is * * * a subrogee of the government and entitled to any rights the government has to the retained funds" (App. 13). In support, it cited cases such as *Prairie State Bank* v. *United States,* 164 U.S. 227, *Henningsen* v. *U.S. Fidelity & Guaranty Co.,* 208 U.S. 404, and *Pearlman* v. *Reliance Ins. Co.,* 371 U.S. 132. But in those cases the United States either was not a party or was in effect a nominal party, or stakeholder. *Munsey Trust* expressly noted (332 U.S. at 240) that the ambit of those cases does not include circumstances such as the present case, where the United States is a party with a direct financial interest in the dispute.

There is nothing in the language in the *Munsey* case which affects this position. The court there

[4] We are aware of no such reported cases other than this one and *Standard Accident Ins. Co.* v. *United States, supra.*

said that the surety on a payment bond has gained nothing by claiming the rights of the laborers and materialmen whom it had paid, since retainages are intended to insure performance rather than payment. But retained progress payments due the contractor, based on work performed prior to default, are retained solely for the benefit of the United States, and in amounts and for a period controlled largely by its own discretion. Where the United States is both a debtor and a creditor, retainages should be no more available to the surety than amounts previously paid to the contractor and no longer available. To give the surety priority to such amounts constitutes a windfall clearly not contemplated by the surety at the time of its initial undertaking, as provided for in the contracts.

That the surety claims through a performance rather than a payment bond presents no difference of substance that warrants enhancing his rights against the retained fund. Those rights should be limited here, as they were in *Munsey Trust*, to the claims of a subrogee of the contractor. Since the United States would have had an unquestioned right to exercise its right of setoff before paying the fund to the contractor, it should have no lesser right as against the contractor's surety.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted.

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MITCHELL ROGOVIN,
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DECEMBER 1967.

APPENDIX

In the United States Court of Appeals for the Fifth Circuit

No. 24246

TRINITY UNIVERSAL INSURANCE COMPANY AND FIRST NATIONAL BANK IN DALLAS, APPELLANTS

v.

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Texas

(September 12, 1967)

Before RIVES, WISDOM and GOLDBERG, Circuit Judges.

RIVES, Circuit Judge: This case presents the clear-cut issue of whether, when a Miller Act [1] surety completes a defaulted contract pursuant to its performance bond, the government may set off taxes owed by the contractor against the surety's claim to the fund retained by the government to insure performance.

Dallas Building, Inc., the contractor, was awarded a contract for the construction of a nuclear warfare laboratory at Kirtland Air Force Base, Albuquerque, New Mexico, for the total sum of $1,008,889.36.

Trinity Universal Insurance Company, the surety, executed for the contractor the two bonds required by the Miller Act; one to guarantee performance and the other payment of laborers and materialmen for

[1] Act of Aug. 24, 1935, c. 642; 49 Stat. 793; 49 U.S.C.A. 270a.

work done. When 90% of the contract had been completed and most of the progress payments made, the contractor defaulted and its right to proceed further was terminated by the government. The retained, unpaid amount earned by the contractor was then $39,906.96, and the amount to be earned upon completion of the remaining work was $67,276.16. Federal unemployment, withholding and F.I.C.A. tax liabilities of the contractor in the amount of $6,495.07 were unpaid.[2]

The surety, in discharge of its obligations, agreed with the government to take over and complete the contract. The surety thereafter expended the amount of $116,623.37 for the work done. It was paid for that work by the government the sum of $67,276.16. In addition, on October 14, 1965, the government paid the surety $33,411.89, the retainage for work done by the contractor less the $6,495.07 owed by the contractor for taxes. In this suit the surety seeks to recover the $6,495.07 setoff.

Upon some of the principles of law involved, the surety and the government are in agreement, viz: 1) The government has no claim against the surety by reason of the taxes of the contractor.[3] 2) The surety has certain equitable or derivative rights, such as rights acquired through subrogation or assignment.[4]

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[2] The record does not disclose whether these taxes arose from the work covered by the contract. We agree with the obvious assumption that that fact was not material. See note 3, *infra*.

[3] General Casualty Co. v. United States, 5 Cir. 1953, 205 F.2d 753, 755; United States v. Crosland Construction Co., 4 Cir. 1954, 217 F.2d 275, 277; United States v. T. E. Hill, 5 Cir. 1966, 368 F.2d 617, 624; United States v. Seaboard Surety Co., N.D. Tex. 1961, 201 F.Supp. 630, 633.

[4] The surety's derivative rights have been discussed in a number of excellent law review articles and comments, *e.g.*: *Reconsideration of Subrogative Rights of the Miller Act Payment Bond Surety*, 71 Yale L.J. 1274 (1962); Cushman, *The*

3) The surety is subrogated to the rights of the contractor, but such rights will, of course, not suffice because the government has a valid setoff against the contractor.[5]

The decisive question in dispute between the parties is whether a surety under a Miller Act performance bond which, under agreement with the government, completes the contract upon contractor's default and expends in such completion more than the full contract price has a right to have the contract price, free from setoff, applied to the completion of the project.

The surety's claim was rejected by the district court upon the authority of *United States v. Munsey Trust Co.*, 1947, 332 U.S. 234. In that case the contractor had failed to pay materialmen and laborers and they had been paid by the surety on the payment bond. The Court held that the laborers and materialmen paid by the surety had no rights to which the surety could be subrogated, and rejected the surety's claim to the retainage free from setoff. The Court noted, however, that a distinction might exist in the case of a surety which chose to complete the contract under its performance bond:

> "Respondent argues that if the work had not been completed, and the surety chose not to complete it, the surety would be liable only

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Surety's Right of Equitable Priority to Contract Balances in Relation to the Uniform Commercial Code, 39 Temp. L.Q. 239 (1966); Comments, *The Surety's Rights to Money Retained from Payments Made on a Public Contract*, 31 Fordham L.Rev. 161; Notes, *Subrogation-Miller Act—Surety's Right to Recover Withheld Funds Under a Government Contract*, 9 N.Y.L. Forum 226; Turner, *The Dutcher Decision in Retrospect*, Insurance Counsel Journal 96 (Jan. 1964).

[5] United States v. Munsey Trust Co., 1947, 332 U.S. 234; Pearlman v. Reliance Insurance Co., 1962, 371 U.S. 132.

> for the amount necessary to complete, less the retained money. Moreover, if the surety did complete the job, it would be entitled to the retained moneys in addition to progress payments. The situation here is said to be similar. But when a job is incomplete, the government must expend funds to get the work done, and is entitled to claim damages only in the amount of the excess which it pays for the job over what it would have paid had the contractor not defaulted. Therefore, a surety would rarely undertake to complete a job if it incurred the risk that by completing it might lose more than if it had allowed the government to proceed. When laborers and materialmen, however, are unpaid and the work is complete, the government suffers no damage. The work has been done at the contract price. The government cannot suffer damage because it is under no legal obligation to pay the laborers and materialmen. In the case of the laborers' bond, the surety has promised that they will be paid, not, as in the case of performance bond, that work will be done at a certain price. The law of damages is therefore not pertinent to the payment bond." 332 U.S. at 244.

In Pearlman v. *Reliance Insurance Co.*, 1962, 371 U.S. 132, 138, the Supreme Court recognized the well-established doctrine that "a surety who completes a contract has an 'equitable right' to indemnification out of a retained fund."* *Munsey* did not disturb this rule, for as the Court noted in *Pearlman:*

> "We held that the Government could exercise the well-established common-law right of debtors to offset claims of their own against their creditors. This was all we held. * * * We hold that *Munsey* left the rule in *Prairie*

*See Prairie State Bank v. United States, 1896, 164 U.S. 227, 239.

Bank and *Hemmingsen* undisturbed." 371 U.S. at 140, 141.

The rights of the surety in *Munsey* were those of a subrogee of the contractor. Whoever, be it the contractor or his surety, pays the laborers and materialmen would be a creditor of the government insofar as the retained funds are concerned. *Pearlman* at p. 141. Of course, however, the government has a right to set off claims against its creditors.

A different situation occurs when the surety completes the performance of a contract. The surety is not only a subrogee of the contractor, and therefore a creditor, but also a subrogee of the government and entitled to any rights the government has to the retained funds.[7] If the contractor fails to complete the job, the government can apply the retained funds and any remaining progress money to costs of completing the job. The surety is liable under the performance bond for any damage incurred by the government in completing the job. On the other hand, the surety may undertake to complete the job itself. In so doing, it performs a benefit for the government, and has a right to the retained funds and remaining progress money to defray its costs. The surety who undertakes to complete the project is entitled to the funds in the hands of the government not as a creditor and subject to setoff, but as a subrogee having the same rights to the funds as the government.[8]

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[7] Compare the rationale employed in the following opinions: Prairie State Bank v. United States, *supra* note 5; Henmingsen v. United States Fidelity & Guaranty Co., 1908, 208 U.S. 404; National Surety Corp. v. United States, Ct.Cl. 1955, 133 F.Supp. 381, 383.

[8] If the government can set off the amount of the unpaid taxes when the surety has completed the job, the surety would be forced to work for less than the contract price. An equity court should attempt to avoid such an unfair result.

We recognize that our holding is in conflict with that of the Court of Claims in *Standard Accident Insurance Co.* v. *United States,* 1951, 97 F.Supp. 829. With deference, however, we cannot agree with that decision.[9]

The same result is reached more directly by the alternative concept that the surety's contract with the government contemplates that the full contract price will be applied to the completion of the contract. Subsequent to the default by Dallas Building, Inc., the surety agreed with the government to take over and complete the principal contract. Implicit in this agreement is the right of the surety to all retained funds and any remaining progress sums. In the words of *Munsey:* "the surety has promised that * * * in the case of performance bond, that work will be done at a certain price." 332 U.S. at 244.

We are not convinced that the government, after entering an agreement such as the one in this case, should have a right to retained funds superior to the

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[9] Note has been taken that the opinion apparently ignores the rule that an obligee, as against a surety, may not apply security in satisfaction of a debt other than the one it secured, and the rationale of the case has been criticized as follows:

> "Such reasoning is clearly erroneous in light of (1) the express declaration of *Munsey* granting the surety superiority where there exists a sound basis of subrogation, (2) the accepted principle of equitable subrogation to the rights of the Government where the surety has benefited the Government by assuming the contractor's duty to pay damages, Prairie State Bank v. United States, 164 U.S. 227 (1896); Hardin County Sav. Bank v. United States, 65 F.Supp. 1017 (Ct.Cl. 1946), and (3) *Munsey's* explicit recognition of the rule regarding diversion of security, 332 U.S. at 243."

Reconsideration of Subrogative Rights of the Miller Act Payment Bond Surety, 71 Yale L.J. 1274, 1286.

rights of the surety.[10] If the government undertook to complete the contract, the surety would be liable for costs exceeding the contract price, but not for taxes owed by the contractor.[11] The surety should not be worse off because it undertakes to finish the job. The performance bond is to assure that the government has a completed project for the agreed contract price. The obligation may be performed, either in kind or in money. Performance results equally when the surety completes the contract or when the surety pays the government any damage which the government incurs in completing the job. In either event, the surety is entitled to have the full contract price applied to the performance of the contract. The judgment is therefore reversed and the cause remanded with directions to enter judgment for Trinity.

REVERSED.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court

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[10] There seems no dispute in the cases that the surety who completes the project has a prior claim to the so-called unearned sums existing when the contractor defaulted. See Massachusetts Bonding & Ins. Co. v. State of New York, 2 Cir. 1958, 259 F.2d 33, 37.

[11] See cases cited in note 3, *supra*. The government's rights to set off funds in its hands is not absolute. See Central Bank v. United States, 1953, 345 U.S. 639, where the Court, construing the Assignment of Claim Act of 1940, 54 Stat. 1029, 31 U.S.C. § 203, "so as to carry out the purpose of Congress to encourage the private contracts," held that the government had no right to set off for the taxes owed by the contractor where a financial institution, as an assignee, was seeking proceeds held by the government.

[Adm. Office, U. S. Courts—E. P. Upton Printing Co., N. O., La.]

for the Northern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed, and that this cause be, and the same is hereby remanded to the said District Court with directions to enter judgment for Trinity Universal Insurance Company.

SEPTEMBER 12, 1967.

Issued as Mandate: October 4, 1967.

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SUPREME COURT, U. S.

DEC 22 1967

JOHN F. DAVIS, CLERK

No. 904

In the

Supreme Court of the United States

OCTOBER TERM, 1967

UNITED STATES OF AMERICA,

Petitioner,

v.

TRINITY UNIVERSAL INSURANCE COMPANY and
FIRST NATIONAL BANK IN DALLAS

BRIEF IN RESPONSE TO PETITION FOR WRIT OF CERTIORARI

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TRINITY UNIVERSAL INSURANCE COMPANY and FIRST NATIONAL BANK IN DALLAS

BRIEF IN RESPONSE TO PETITION FOR WRIT OF CERTIORARI

For the purpose of this memorandum, respondents adopt the statements contained in the Government's petition under the headings "Opinions Below," "Jurisdiction," "Question Presented," and "Statement," except that respondents show that the opinion is unofficially reported in 382 F. 2d 317.

ARGUMENT

I. The decision of the court below is plainly correct.

The decision of the court below states better than respondents can hope to these fundamental principles of law upon which it rests, and which no court has ever questioned:

1. The retainage is a security for the benefit of the surety who performs the contract.

In Prairie State Bank,[1] this court said:

"* * * the reserved per cent, to be withheld until the completion of the work to be done is as much for the

[1] Prairie State National Bank v. United States (1896) 164 U.S. 277, 17 S. Ct. 142, 41 L. Ed. 412.

> indemnity of him who may be a guarantor of the performance of the contract as for him for whom it is to be performed."

More than 65 years later, this Court in Pearlman[2] noted its adherence to Prairie State Bank and reaffirmed the principle that "a surety who completes the contract has an equitable right to indemnification out of the retained fund."

The court below properly applied the elementary rule that an obligee may not divert security for the surety's obligation to the satisfaction of debts for which the surety is not bound.

> ***2. The obligee in a performance bond cannot, by application of the retainage to a debt for which the surety is not liable, require the surety to complete the work at a price less than that agreed upon.***

In Munsey Trust, (332 U.S. at 244) this Court said:

> "But when a job is incomplete, the Government must expend funds to get the work done, and is entitled to claim damages only in the amount of the excess which it pays for the job over what it would have paid had the contractor not defaulted."

The court below stated in this connection:

> "If the government can set off the amount of the unpaid taxes when the surety has completed the job, the surety would be forced to work for less than the contract price. An equity court should attempt to avoid such an unfair result." (Appendix to the Petition, page 13, note 8.)

[2] 371. U.S. 132, 138 (1962)

Respondents submit that to allow the obligee to setoff does more than create a mere inequity or unjust result. It empowers an obligee to create a new contract requiring the surety to complete construction at a price less than that agreed upon. It violates fundamental principles of contract law and of the law of damages.

II. Standard Accident Insurance Co. v. United States, (1951) 97 F. Supp. 829, did not challenge, and certainly did not refute, the basic principles applied by the court below.

Standard Accident merely ignores basic principles; and in so doing is justly subject to the succinct criticism which was noted by the court below, (App. Pet. p. 14, n. 9):

> "Such reasoning is clearly erroneous in light of (1) the express declaration of Munsey granting the surety superiority where there exists a sound basis of subrogation, (2) the accepted principle of equitable subrogation to the rights of the Government where the surety has benefited the Government by assuming the contractor's duty to pay damages, Prairie State Bank v. United States, 164 U.S. 227 (1896); Hardin County Sav. Bank v. United States, 65 F. Supp. 1017 (Ct. Cl. 1946), and (3) Munsey's explicit recognition of the rule regarding diversion of security, 332 U.S. at 243."

III. The petition for certiorari does not challenge the correctness of the principles upon which the decision of the lower court is based.

The petition is based upon the following:

1. The naked assertion of the Solicitor General that there is no difference of substance between claims arising through

performance bonds and payment bonds. But there is no attempt to show wherein the court below and this court in Munsey Trust were in error in making a distinction.

2. The out-of-the-record statement that the United States has routinely exercised the right of setoff with the acquiescence of the surety.

Respondents suggest that the paucity of the decisions on the precise point indicates, not an acquiescence in the position asserted by the Government, but rather an avoidance of the issue by refusing to complete the construction and allowing the Government to proceed. As shown by what this court said in Munsey Trust, the Government, in any suit against the surety, would have to account for the entire contract price, and not the contract price less what the contractor might otherwise owe the United States.

At any rate, the Government cannot by its own actions establish a rule of law binding on any court.

3. The declaration that "to give the surety priority constitutes a windfall clearly not contemplated by the surety at the time of its initial undertaking."

The innumerable cases in which sureties have vigorously asserted their rights to the retainage in the courts of the United States and all of the states of the Union for the more than 70 years since Prairie State Bank refutes the statement that sureties do not contemplate the security of the retainage.

IV. It is manifest that the decision of the court below is correct. But if in the opinion of this Court a denial of the writ of certiorari is likely to increase litigation or result in any uncertainty which should be put at rest, then it is suggested that in view of the clarity of the issues decided by the court below, it would be appropriate for the court to grant the certiorari and summarily affirm the decision of the court below.

CONCLUSION

The petition for certiorari should be denied, or, in the alternative, the writ should be granted and the decision below summarily affirmed.

Respectfully submitted,

LLOYD E. ELLIOTT,
Attorney for Respondents.

CERTIFICATE OF SERVICE

I, L. E. Elliott, do hereby certify that on this date there was deposited in a United States mail box, with airmail postage prepaid, addressed to Erwin N. Griswold, Solicitor General, United States Department of Justice, Washington, D. C. 20530, five (5) copies of the foregoing Brief in Response to Petition for Writ of Certiorari.

This the .... day of December, 1967.

L. E. Elliott